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¶1. Summary. The flat tax is the flagship of the reform agenda that helped the government of Prime Minister Mikulas Dzurinda quickly turn Slovakia into one of Europe's most attractive destinations for global investment. While admired by investors, Slovakia's flat rates for income, corporate, and value-added taxes are a primary target for the front-running Smer opposition party, which would like to re-introduce graduated tax rates and the dividend tax. Smer's tax proposals may attract voters but worry the business community, and it is hard to see how it can assemble a post-election coalition to implement its tax reform ideas. Slovakia's high payroll taxes, a more likely target for post-election reform, have not become a major issue during the campaign. End summary.

Last Four Years Defined by Tax Reform

¶2. The 2004 tax reform was designed to simplify the tax system by eliminating more than 200 exemptions and special regimes and setting the rates for the personal income tax, the corporate income tax and the value-added tax (VAT) at a flat 19 percent. This amounted to a net decrease in income and corporate taxes, but a net increase in value-added taxes. The withholding tax on dividends, the succession tax, the gift tax and the real estate transfer tax were abolished to pursue the principle of no double taxation of saving and investment. In addition, excise duties on mineral oils, tobacco and tobacco products, wine and beer were raised in order to be fully harmonized with EU regulations as required by Slovakia's accession treaty with the EU.

¶3. The tax reform package has not significantly altered the national budget, since increased revenue from value-added and excise taxes have largely balanced decreases from other taxes. After Slovakia introduced tax reform, tax revenues fell by only 0.1 percent of GDP, from 18.1 in 2003 to 18.0 in 2004 and revenues increased in cash terms. The simple regime also improved compliance and has reduced the need for individuals and businesses to seek creative ways to avoid paying taxes. To address the potential problem of regressive taxation associated with higher value-added taxes and higher income tax levels in lower income brackets, the GOS significantly increased personal deductions so that those with incomes below SKK 9,000 per month (USD 300) do not pay income tax at all. As a result, even citizens who were previously paying the lowest income tax rate of 10 percent benefit from the new system.

Wide support for further income tax cuts...

¶4. Most political parties are courting voters by calling for further income tax cuts; in fact there in something of a competition to come up with lowest number. Within the ruling coalition, Dzurinda's SDKU calls for cutting personal income and corporate tax by one percentage point each year of the new electoral term, to 15 percent in 2010. The drop in revenues would be compensated for by an "energy tax" and increased EU funds. SMK is more restrained, proposing to cut income taxes to 17 percent. Former coalition members are calling for deeper and faster tax cuts: KDH calls for reducing income taxes to 14 percent over the term, while ANO wants 15 percent tax rates by ¶2008. KDH also proposed doubling the non-taxable threshold and allowing families to deduct an additional SKK 100,000 during the first year of marriage. (NOTE: KDH's campaign was focused on "family values"). Vladimir Meciar's HZDS has been surprisingly friendly to the tax reform package, saying that he "does not disagree with the flat tax concept." Free Forum would "preserve the system with further reduction of income tax rates." Despite all these proposals, there is little evidence that income tax cuts are a voter priority this year.

... but not a consensus

¶5. Taxes are a centerpiece of Smer's criticism of the Dzurinda government, and is also the business community's main concern about a Smer-led government. Smer has promised to enact a system similar to what existed before the Dzurinda reforms. Above all, progressive income taxes would be re-introduced. The Smer tax regime would be based upon three tax brackets: 15 percent tax for annual incomes of up to SKK 240,000 (USD 8,000); 19 percent for

incomes above SKK 240,000 and up to SKK 600,000 (USD 20,000) and 25 percent for the richest. The communist party (KSS) and the nationalist party (SNS) have also called for a graduated tax system, but have been less specific on details.

¶6. Smer is the only party that proposes specific tax increases for business. While leaving the corporate rate at 19 percent for "regular companies", it wants to impose a special, 25 percent tax "for all natural monopolies, strategic enterprises, banking and financial institutions." Without explaining which companies would be subject to the new "monopoly tax," Smer calculates that it would generate revenues of approximately SKK 4 billion (USD 133 million). Independent analysts estimate that such change would increase revenues by no more than SKK 3.1 billion, due to lower income of the state as a shareholder from dividends as the overall profit will be squeezed by the higher tax bite.

¶7. Smer and SNS both plan to bring back the withholding tax on dividends, which was abolished in 2004, and increase it from its former level of 15 percent to 19 percent. SMER estimates revenues from this measure at SKK 9.8 billion for 2006. This number differs significantly from independent assessments, which estimate additional revenue of only SKK 0.8 billion since non-residents would be inclined to pay taxes elsewhere if taxed on dividends in addition to the corporate income tax. In 2003, the last year before the dividend tax was abolished, it brought into the state budget less than SKK 500 million. Smer's revenue projections leave open to question whether it understands the degree of impact its tax policies will have on investors. Also, considering that Smer has a sizeable number of domestic corporations supporting its campaign, it is unclear how it would be able to actually move forward on such a proposal.

¶8. Smer would also lower taxes in other areas, especially value-added taxes, as part of its effort to build the "social state." Specifically, it would re-introduce a two-tier VAT system, with lower rates applied for foodstuffs, medicals, books, utilities, and eventually other goods and/or services. The lower rate would be reduced to 14 percent in the first phase, and later to 10

percent. The party expects that the measure would reduce state budget revenues by SKK 7.5 billion (250 million USD) in 2006, which independent analysts agree is a realistic projection. Smer would also decrease excise taxes on gasoline and diesel. KSS has also called for a two-tier system, lowering VAT on basic goods to 10 percent, while SNS has called for lowering VAT but has not offered a specific plan. Among the parties that pioneered tax reform, only KDH has seriously mentioned the possibility of reducing value-added taxes on some goods, but has not offered a firm proposal.

Payroll taxes

¶9. In contrast to previous elections, much of this year's campaign debate is focused on Slovakia's health, social security, and welfare insurance systems. All of these sectors are financed by payroll taxes, which were marginally reduced but otherwise unaffected by the GOS reform package. Overall payroll taxes in Slovakia remain the highest of the Visegrad countries, and high by EU standards. In Slovakia, employees pay on average 13.4 percent of their wages in payroll taxes. In addition, employers are assessed payroll taxes of 35.2 percent on top of employee wages, which dramatically increases labor costs for business. Consequently, taxes on capital in Slovakia are much lower than taxes on labor, which encourages capital- instead of labor-intensive investment in a country that still has an unemployment rate of 11 percent. The payroll tax system is particularly unfavorable to poorer and less-educated regions such as Eastern Slovakia, where labor productivity is lower.

¶10. Most of the front-running parties recognize this problem to some degree, and parties ranging from SDKU to Smer have suggested payroll tax reform. Parties have not been very specific in their payroll tax reform platforms, however, even though the current system is highly unpopular and no party has a serious stake in preserving it, which suggests that reform is possible. Former and current ruling coalition parties - SDKU, KDH, SMK, and ANO - have called for relaxing the payroll tax burden, and uniting the collection of diverse payroll taxes under one office to reduce administrative costs. These parties also seem to agree on the need to unify payroll tax assessment bases by shifting the portion of payroll taxes paid by the employer to the employee and recalculating wage rates (upward) accordingly. Under this system, gross wage rates would be equal to the cost of labor plus payroll tax-financed social benefits. This change would solve past problems with companies that have failed to pay their payroll tax obligations. Notably, SDKU and other parties have

not been specific about payroll tax rates. Smer's position on payroll taxes is even less defined, a result of wanting to lower taxes while simultaneously increasing expenditures on health care, pensions, and other social insurance.

(11. While parties have been loathe to discuss significant payroll tax schemes, Richard Sulik, former advisor of Finance Minister Ivan Miklos and author of the flat tax reform, has put forward a specific proposal. Sulik calls for a payroll tax schemes with a single "redistribution contribution" rate equal to 18 percent of all labor income and a single "contribution bonus" equal to the minimum subsistence level. In this scenario, the state would provide basic health care, and all other social insurance would become private, including pensions. Higher employment and tax revenues would be expected to finance part of the transition cost and any special arrangements for particularly vulnerable groups like disabled and single mothers. This model, which would radically reduce and restructure payroll taxes, has been endorsed by the influential Alliance of Entrepreneurs in Slovakia. It has not gained the official support of any major party.)

Coalitions and Tax Policy

¶12. Slovakia's economy is growing at a rate of 6 percent per year, and unemployment has fallen from 20 to 11 percent since

¶2002. Most observers in Bratislava believe that Slovakia's tax reforms greatly facilitated this boom, but voters in other parts of Slovakia are less willing to give the government credit and are more willing to give Robert Fico and Smer a chance. But Fico would find governing much more difficult than winning first place in the election. To form a coalition, Smer will need to unite with partners like SMK, KDH, or perhaps HZDS, all of which disagree with most of Smer's tax policy proposals. SNS and KSS, which agree more closely with Smer, are not viewed as viable partners, and the latter may not make it into parliament. As a result, Smer will likely have to back out of the great majority of its proposed tax reforms, especially those on corporate and personal income taxes. Changes to value-added taxes and payroll taxes are more plausible, but it is unclear what direction those reforms will take. In any case, Smer will find it almost impossible to deliver on its key tax reform campaign promises.

VALLEE